

***Bonus Programs
Within Tax-Exempt
Organizations
in a***



*by
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*Bonus Programs
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The Internal Revenue Service has taken the position that:

Exempt organizations can establish and operate incentive plans that devote a portion of receipts to reasonable compensation of productive employees so long as the benefits derived from the plans generally accrue not only to employees but also to charitable employers through, for instance, increased productivity and cost stability, thus aiding rather than detracting from the accomplishment of exempt purposes.¹

Does the agency thus smile upon the traditional performance-based incentive plans found in commercial enterprises? Largely, but not entirely, as we shall see.

On January 6, 2006, the Internal Revenue Service issued its Private Letter Ruling 200601030 in response to a request by a 501(c)(3) exempt organization proposing to:

adopt a Long-Term Incentive Bonus Program [sic]...in order to provide financial incentives for senior managers...to achieve the specific measurable goals that will continue and advance [the organization's] tax-exempt purposes by maintaining the level of human and capital assets necessary to achieve its strategic agenda. The Program is intended to provide financial incentives to, and rewards for, eligible employees who make key contributions to [the organization's] core operations and to the development...of commercial uses for [the organization's] core operations and to the development...of commercial uses for [the organization's] science and technology discoveries.

The letter goes on to describe a fairly elaborate incentive program, to be administered by the compensation committee of the organization's board of directors, the beneficiaries of which program would include:

- The organization's CEO,
- Executive officers other than the CEO, and
- Non-executive senior managers.

Each category and individual is distinguished as having "primary responsibility for the success of [the organization's] core operations...." Thus identified, every person will receive individual performance objectives at the start of the fiscal year. After the completion of the fiscal year, the individual's objective performance will be documented and assigned a "performance score reflecting the participant's level of achievement of the participant's individual performance objectives." This performance score will provide the reference for the potential bonus for the fiscal year, which will be expressed as a percentage of base salary.

¹ 1983 EO CPE Text, Chap. D. Inurement, Sec. 3.B.1. Excessive Compensation (unpaginated).

The Internal Revenue Service found in favor of the undisclosed requesting organization, ruling that the “adoption and operation of the Program is consistent with the requirement that an organization described in Section 501(c)(3) of the Code operate exclusively for one or more exempt purposes and will not jeopardize [the organization’s] tax-exempt status under section 501(c)(3).”

Private Letter Ruling 200601030, by law and its terms, “is directed only to the organization that requested it...[I]t may not be used or cited as precedent.” Assuming, however, that an exempt organization already has an executive bonus plan in effect or that it is contemplating the use of one, how can it best make the result palatable to the agency? We offer some observations, based upon the circumstances of Private Letter Ruling 200601030 and our own experiences in the field of compensation consulting.

The following may serve as a checklist (with quotations from operative language of Private Letter Ruling 200601030) for a Section 501(c)(3) organization reviewing a bonus program:

Overall

- ✓ Establish and maintain a standing compensation committee of the board with, at least, a simple majority of independent membership.
- ✓ Adopt a conflict of interest policy applicable to executives, the board, and any third parties whose services the board may retain.
- ✓ Charge the compensation committee with responsibility for promoting and sustaining the organization’s goals and health through establishment of individual financial rewards and incentives, objectively derived and consistent with the requirements that the rewards and incentives be reasonable and that the organization in no sense is operated for the benefit of their pecuniary beneficiaries.
- ✓ Empower the compensation committee with full authority to:
 - Design,
 - Award,
 - Modify, and/or
 - Cancelany or all proposed compensation and benefits awards, including individual bonuses.²
- ✓ Authorize the compensation committee to retain the services of and to consult with:
 - Organizational employees,
 - Attorneys,
 - Accountants,

² It may be preferable, as with this letter ruling, to allow the full board to have authority over awards made to the chief executive officer or functional equivalent.

- Compensation consultants, and/or
 - Other experts
- of its own choosing.

As to the Compensation Committee

- ✓ Define the organization’s “core operations.”
- ✓ Identify those executives who have “primary responsibility” for the success of the core operations.
- ✓ Determine those “specific measurable goals” that will “continue and advance” the organization’s tax-exempt purposes.
- ✓ Assign specific measurable goals to each executive or manager already identified with respect to core operations.
- ✓ Design and implement an objective financial model for potential bonus awards, subject to an appropriate cap or ceiling.
- ✓ Assign bonuses in cash and as a percentage of the individual’s base salary.
- ✓ Review each award to ensure that total compensation is “reasonable.”³
- ✓ Administer disbursement of bonus awards.
- ✓ Consult with independent compensation consultants, attorneys, and other experts, as necessary, to accomplish the preceding.

We hope this brief introduction will prove useful to your understanding of a complex issue. Should you have any further questions or if the Organizational Consulting Group can assist your organization with its compensation planning, please contact a representative of OCG.

³ For certain executives who may be “disqualified persons” under the intermediate sanctions rules of IRC Section 4958, this may require a separate analysis to establish a “rebuttable presumption of reasonableness.”